Negative Reserves – Time to Wake Up to Reality

Shriram Mulgund, FIA; FASI

1. Background

During my annual visit to India in December 2004 – January 2005, I had an opportunity to present a CPD seminar on "New Product Pricing" in Pune. During the course of the presentation, the question of negative reserves under the Universal Life type of products came up for discussion. This discussion has prompted me to write this article.

From the discussion at the session, it appeared to me that the professional guidance provided by the ASI was resulting in the actuaries having to set up reserves higher than envisaged by the legislation. It seems necessary that the present situation be reviewed with some degree of urgency. I would welcome membership discussion on this important issue.

The question of whether or not negative reserves should be permitted is not new. It was hotly debated in the early stages of the discussions that were held when the new Regulations were being drafted. At that time, while the IRDA seemed receptive to the idea of permitting negative reserves (or reserves less than cash values), the profession seemed to be uncomfortable with that concept. As a result, the Regulations specify that for financial reporting purposes, the reserve held under a policy should not be negative or be less than the cash value. In the balance of this article, I will confine myself only to the negative reserve aspect of the reserves.

2. Provisions in the Valuation Regulations and the Professional Guidance

The IRDA (Assets, Liability and Solvency Margin of Insurers) Regulations, 2000 deal with the question of negative reserves as follows:

Shriram Mulgund,
Toronto, Canada
mulgund@sympatico.ca

- Section 5 of Schedule II-A specifies that for the purpose of financial reporting, the reserve held under a policy should not be negative. If negative, it will be set to zero.
- Section 7 of the same schedule deals with the reserves under linked contracts. Any negative reserves under the general fund are to be dealt with in accordance with Section 5.

Guidance Note 2 (Additional Guidance Note for AA's) addresses this question. Section 4.5 stipulates that ".....Neither the unit reserve nor the non-unit reserve in respect of a policy shall be negative".

It is my understanding that the IRDA regulations for linked products allow the two components of the policy to be combined before performing the test.

This will suggest that while the IRDA Regulations seem to require that the total of the two component reserves held in respect of a linked policy should not be negative, GN2 specifies that each of the components should separately be non-negative. It is this inconsistency that is the root cause of the present problem.

3. An Example for UL type of Product

It will be interesting to look at an example. Assume that two Universal Life type of policies A and B are issued. Under policy A, the investments are made within the life fund itself (accumulation with interest) and under policy B, the investments are made under a linked fund. Other particulars are as follows:

First year premium: Rs.1,000

First year loading: 5% (95% is invested in accumulation fund or in units)

First year expenses: Rs.1,000.

Surrender Value during the first year: Zero.

The treatment of the two policies will go along the following lines (for simplicity, the cost of death benefits is ignored):

Policy A

- The accumulation account will be credited with 950 (premium of 1,000 less a loading of 5%).
- The first year expenses will be 1,000. The asset share will be equal to zero.
- At the first valuation after issue, a zero reserve can be held. This will be okay since the cash value will also be zero.
- The first valuation will impose no financial strain on the insurer.

- If the policy is surrendered, as no cash value is payable, no strain will result.

Policy B

- An amount of 950 will be transferred to the linked fund and the policyholder will be credited with units worth 950.
- The general fund will receive the first premium loading of 50 and incur expenses of 1,000. Thus, the asset share in the general fund will be (- 950).
- At the first valuation after issue, the reserve to be held by the linked fund will be 950 and the general fund reserve will have to be set to zero. Thus, even though the insurer has spent the entire first year's premium, it has to hold a total reserve of 950 (under the two components combined). This amount has to be funded by the shareholders through capital infusion.
- If the policy is surrendered, the amount of 950 held by the linked fund is passed on to the general fund, which is able to use the entire amount to wipe out the negative asset share (no surrender value is to be paid).

4. Implications of the Current Practice

The above example illustrates the following:

- The valuation legislation envisages that a policy, considered as the total of all its components, will not hold a negative reserve. This will mean that for policy A, a zero reserve can be held. For policy B, if the two components are considered together, the linked fund will hold a reserve of 950 and the general fund can hold a reserve of (-950). Thus, regardless of how the investment portion of policy is handled (either within the life fund or in a linked fund), the treatment given to the policy will be identical. The reserve strain for both policies will be identical. This seems perfectly logical.
- The application of GN2 requires the AA to consider the two components of policy B separately and hold a zero reserve under the general fund. On this basis, the total reserve will be zero for policy A and 950 for policy B. Thus, an insurer issuing policies of type B will need to finance increased new business strain. It seems illogical that creation of two components (to deal with different investment patterns) should result into a big increase in the reserve – particularly when the legislation does not seem to require it.
- The intent behind the current legislation is that for a given policy, the total reserve should not be less than the cash value. The concept of considering the two components together for Policy B can be employed within this framework. The level of the negative reserve in the general fund can be limited so that the absolute value of the negative reserve does not exceed the surrender charge applicable at the time of valuation. This ensures that if the policy is surrendered, no strain will result – precisely the intent behind the legislation. In the U.K, where the general fund reserves are called "Sterling Reserves", are subjected to this surrender charge cap.
- Whenever the general fund carries negative asset shares, the GN2 prescription for the general fund reserves requires insurers to inject capital to set the general fund reserves to zero. This capital injection seems to be totally unnecessary. It provides no additional protection to the policyholders. The GN2 requirement results in putting roadblocks in the insurer's way and could seriously limit its growth. It could also inhibit the introduction of innovative products in India.

5. Future Direction

As discussed above, the IRDA Regulations, in my view, permit the combined treatment of the two components for type B policies, so that the general fund reserve can be negative (to the extent of the surrender charge). In other words, policies of type A and B are both treated in the same way.

It is very much necessary that this issue be fully discussed by the membership at large and the present inconsistency rectified.

At the global conference in February 2005, I discussed this issue with a number of members of the ASI. Almost all of them seemed to be in tune with my thinking.

Can the profession wake up to the reality and have an open discussion on this issue and take steps to effect the change?

In this article, I have not addressed the general question of reserves that could be less than cash values. Whether to permit such reserves, is yet another question. That will be a topic for another time!